

**REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE PROVINCIAL  
LEGISLATURE AND COUNCIL ON THE FINANCIAL STATEMENTS AND  
PERFORMANCE INFORMATION OF MANGAUNG LOCAL MUNICIPALITY FOR  
THE YEAR ENDED 30 JUNE 2008**

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I was engaged to audit the accompanying financial statements of the Mangaung Local Municipality (MLM) which comprise the statement of financial position as at 30 June 2008, statement of financial performance, statement of changes in net assets and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, as set out on pages [xx] to [xx].

**Responsibility of the accounting officer for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting determined by the National Treasury, as set out in accounting policy note 1, in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA) and the Division of Revenue Act, 2007 (Act no.1 of 2007) (DORA). This responsibility includes:
  - designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
  - selecting and applying appropriate accounting policies
  - making accounting estimates that are reasonable in the circumstances.

**Responsibility of the Auditor-General**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these financial statements based on my audit in accordance with the International Standards on Auditing and *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*. Because of the matters discussed in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.
4. Paragraph 11 *et seq.* of the Statement of Generally Recognised Accounting Practice, GRAP 1 *Presentation of Financial Statements* requires that financial reporting by entities shall provide information on whether resources were obtained and used in accordance with the legally adopted budget. As the budget reporting standard is not effective for this financial year, I have determined that my audit of any disclosures made by the MLM in this respect will be limited to reporting on non-compliance with this disclosure requirement.

**Basis of accounting**

5. The municipality's policy is to prepare financial statements on the basis of accounting determined by the National Treasury, as set out in accounting policy note 1.

## **Basis for disclaimer of opinion**

### **Property, plant and equipment**

6. As a result of the audit matters detailed below, I was unable to obtain sufficient appropriate audit evidence to gain adequate audit assurance as to the completeness, existence, valuation, presentation and disclosure of and the municipality's rights to property, plant and equipment with a carrying value of R2 120 428 600 (2007: R1 853 931 458), as disclosed in note 9 to the financial statements for current and prior financial year:
  - (a) For assets with a carrying value of R954 682 146 (2007: R1 223 451 864) the descriptions, serial numbers, location and condition of items as indicated in the fixed asset register were inadequate. Furthermore, the municipality did not conduct an asset verification during the year. The municipality's records did not permit the performance of alternative audit procedures and therefore I was unable to perform all the procedures I considered necessary to obtain adequate audit assurance as to the existence, valuation, completeness, presentation and disclosure of and the municipality's rights to property, plant and equipment to this amount.
  - (b) Insufficient information was included in the erven list to enable me to obtain adequate audit assurance as to the municipality's rights with regard to erven to the value of R109 075 200 (2007: R116 292 300). The municipality's records did not permit the performance of alternative audit procedures regarding its rights to the erven.
  - (c) An amount of R110 055 868 was disclosed as a decrease in revaluation of land and building assets as per note 9 to the financial statements. I could not be provided with detailed explanations and a breakdown of this amount. This amount was further disclosed together with disposals in the current year, amounting to R6 608 545 per note 9, as a deduction for asset disposals amounting to R116 664 412 against the accumulated surplus in the statement of changes in net assets. The entity's records did not permit the performance of alternative audit procedures regarding these adjustments. Consequently, I could not determine the completeness and valuation of the revaluation reserve, the accumulated surplus and property, plant and equipment.
7. A portion of the immovable property of the former Botshabelo Transitional Local Council that was registered in the name of the Free State Provincial Government was transferred to MLM during the year ended 30 June 2005. At year-end the value of the land and buildings had not yet been determined and recorded in the fixed asset register of MLM. The municipality's records did not permit the performance of alternative audit procedures regarding the valuation of the land. Property, plant and equipment and the revaluation reserve are therefore understated by an unknown amount in the financial statements.
8. Erven with a value of R9 839 100 included in property, plant and equipment, as disclosed in note 9 to the financial statements, does not conform to the definition and recognition criteria of Property, plant and equipment as stated in the Standard of Generally Accepted Municipal Accounting Practice GAMAP 17: Property, plant and equipment (GAMAP 17) and should not be recorded as property of the municipality. Consequently, property, plant and equipment and the accumulated reserve are overstated by R9 839 100.
9. Erven with a value of R8 031 700 (2007: R5 819 700) which conform to the definition and recognition criteria of Property, plant and equipment as stated in GAMAP 17 and were identified as municipal property on the valuation roll, were

not included in the fixed asset register for the year ended 30 June 2008. Consequently, property, plant and equipment and the revaluation reserve are understated by this amount.

10. During the prior year, housing scheme assets with a cost of R52 457 100 were added to the fixed assets register. These assets had already been included in the fixed asset register when they were created and are therefore duplicated in the fixed asset register and in the financial statements. Consequently, property, plant and equipment at cost was overstated by R52 457 100, accumulated depreciation was overstated by R40 784 900 and the accumulated surplus was overstated by R11 672 200 for both the current and prior financial year.
11. The municipality has not accounted for property, plant and equipment in accordance with the Standard of Generally Recognised Accounting Practice, GRAP 1 *Presentation of Financial Statements (GRAP 1)* and the Standard of Generally Accepted Municipal Accounting Practice, GAMAP 17 *Property, Plant and Equipment (GAMAP 17)*, read with the exemptions in *Government Notice 522 of 2007*, issued in *Government Gazette No. 30013 of 29 June 2007* in the following respects:
  - (a) GAMAP 17 paragraph 10 requires an asset to be recognised when it is probable that future economic benefits or service potential associated with the asset will flow to the municipality. The municipality capitalised certain expenses amounting to R18 829 695 (2007: R54 921 465) that did not meet the definition of an asset in the current and prior financial year. Consequently property, plant and equipment was overstated and expenditure understated by this amount. Furthermore the depreciation expense will be overstated with the depreciation expense resulting from the capitalisation of these expenses in the current and prior financial year.
  - (b) Paragraphs 76 and 8 of GAMAP 17 require a municipality to disclose assets under construction and heritage assets separately in the financial statements. Assets under construction and heritage assets had not been identified and are not disclosed separately in the financial statements. The municipality's records did not permit the performance of alternative audit procedures regarding assets under construction and heritage assets. Consequently, I could not determine the completeness and existence as well as the extent to which these assets were accurately classified in the financial statements.
  - (c) In accordance with paragraph 41 of GAMAP 17, accounting policy note 7 indicated that MLM measures land and buildings by using the revaluation model. Contrary to the accounting policy, the city council erven listing reflected a total of 938 erven (2007: 2 837 erven) with zero values which had not been revalued. The municipality's records did not permit the performance of alternative audit procedures regarding the completeness and valuation of these erven. Consequently, property, plant and equipment and the revaluation reserve were understated by an undetermined amount.
  - (d) Paragraph 39 of GAMAP 17 requires the municipality to account for major components of some items of property, plant and equipment separately because they have useful lives different from those of the items of property, plant and equipment to which they relate. Contrary to this requirement, significant components with a useful life that differed from that of the main asset have not been identified and depreciated separately. The municipality's records did not permit the performance of alternative audit procedures regarding the componentisation of assets. Consequently, I could not determine the amounts by which property, plant and equipment and depreciation were misstated.

12. Contrary to the definition of an asset as stated in GRAP 1, animals, owned by the municipality and housed in the zoo and nature conservation areas within the Mangaung district, have not been recorded in the fixed asset register and accounted for in the financial statements. Given that a formally approved and documented policy framework regarding the management and valuation of these animals was not in place during the year under review and the municipality had not adopted an accounting policy in this regard, I was unable to obtain sufficient appropriate audit evidence to determine the completeness, valuation, existence, allocation and fair presentation of and the rights and obligations of these assets. The municipality's records did not permit the performance of alternative audit procedures regarding these assets. Consequently, the financial statements as at 30 June 2008 are misstated by an unknown amount.
13. Contrary to the South African Statement of Generally Accepted Accounting Practice (SA GAAP), IAS 38 (AC 129) *Intangible Assets*, read with the exemptions in *Government Notice 522 of 2007*, issued in *Government Gazette No. 30013 of 29 June 2007*, computer software and website costs with a carrying value of R7 619 614 (2007: R10 076 905) have been inaccurately classified as property, plant and equipment for current and prior financial year. The amortisation costs associated with these intangible assets, which amount to R2 543 968 (2007: R3 181 963), have also been inaccurately classified as depreciation in the statement of financial performance for the current and prior financial year.
14. The depreciation on property, plant and equipment as disclosed in the statement of financial performance amounts to R98 407 204 (2007: R99 441 851). However, due to the matters listed in paragraphs 6 to 13 above I was unable to confirm the accuracy of the depreciation charge for the year. The municipality's records did not permit the performance of alternative audit procedures regarding the depreciation charge. Consequently, the depreciation expense and property, plant and equipment are misstated by an unknown amount.
15. Due to the lack of sufficient appropriate audit evidence, I am unable to quantify the extent of the resulting misstatement or to determine the affected account balances, classes of transactions and disclosures in the financial statements.

#### **Long-term receivables**

16. Paragraph 58 IAS 39 (AC133) *Financial Instruments: Recognition and Measurement* (IAS 39) requires the municipality to assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. Contrary to this requirement, the municipality did not test long-term receivables for possible impairment. Based on my assessment of the long-term receivables, as disclosed in note 11 to the financial statements, there is objective evidence that the long-term receivables are impaired and overstated by R7 570 502 (R7 100 000) and resulting in the corresponding bad debts expenditure being understated by the same amount.

#### **Consumer and other receivables**

17. Paragraph 58 of IAS 39 requires the municipality to assess at each balance sheet date whether there is any objective evidence that a financial asset or group of financial assets is impaired. The municipality only made a general provision for doubtful consumer receivables which is not in accordance with the impairment requirements of IAS 39. No provision for doubtful debts has been recognised on the other receivables although there is objective evidence of impairment. As the relevant information was not available I was not able to determine what the

impairment charge against consumer and other receivables and bad debts should have been had IAS39 been applied correctly.

18. A suspense account with a balance of R6 957 274, outstanding since 30 June 2005, included in note 14 to the financial statements, was not cleared as at 30 June 2008 and showed no movement for the year under review or after year-end. Furthermore, no supporting documentation could be submitted to gain adequate audit assurance as to the existence and valuation of and the rights and obligations relating to the balance. The municipality's records did not permit the performance of alternative audit procedures regarding this suspense account.
19. Contrary to the requirements of paragraph 30 of GRAP 1, the municipality did not provide for service charges relating to the period between the last meter-reading date and the year-end date on an annual basis. As a result, the consumer receivables are understated by R8 518 977 (2007: R10 321 211) and the accumulated surplus was understated by R10 321 211 (2007: R11 743 258). Revenue for the year under review was overstated by R1 802 234 (2007: R1 422 047).
20. A Gentlec debtor account, amounting to R5 006 410, was incorrectly included in MLM's consumer receivables balance at year-end. Consequently, consumer receivables and payables were overstated in the financial statements by this amount.
21. No supporting documentation for journals totalling R84 082 792 (2007: R34 177 534), which impacted on consumer and other receivables and service charges, could be obtained. I could therefore not determine whether these journals were valid and accurately recorded and could therefore not gain adequate audit assurance as to the valuation and allocation of consumer and other receivables and the accuracy, completeness and occurrence of service charges. The municipality's records did not permit the performance of alternative audit procedures regarding these journals.
22. Corrections regarding re-allocations between rates and sanitation accounts of government departments during the year under review were only made after year-end. As a result, note 13 to the financial statements indicating the split of debtor balances between services were inaccurately classified and rates consumer debtors were overstated by R28 834 523 and sanitation consumer debtors were understated by R28 834 523.

#### **Accumulated surplus – funds**

23. The carrying value of assets, financed through reserves, and which had been disposed of in previous financial years was not deducted from the applicable reserves in the statement of changes in net assets in the prior financial year. Consequently, the government grant reserve was overstated by R395 462, the capitalisation reserve by R4 623 903 and the capital replacement reserve by R2 482 119 while the accumulated surplus was understated by R6 330 334. Furthermore, the adjustments related to prior period errors and are not disclosed as prior period errors in accordance with the Statement of Generally Recognised Accounting Practices (GRAP 3) *Accounting Policies, Changes in Accounting Estimates and Errors*.
24. With reference to paragraphs 6(c), 7, 8 and 9 above I could not obtain sufficient supporting evidence for an amount of R121 728 068 disclosed as the movement between the revaluation reserve and the accumulated surplus for the current year in the statement of changes in net assets. Alternative audit procedures could not be performed due to insufficient supporting documentation. Consequently, I could

not gain adequate audit assurance as to the completeness, valuation and existence of the revaluation reserve and the accumulated surplus disclosed in the statement of changes in net assets.

25. Paragraphs 17, 89 and 114 of GRAP 1 require the profit or loss on the disposal of assets to be disclosed in the statement of financial performance. Contrary to this, assets with a carrying value of R6 608 545 disclosed as disposals in note 9 to the financial statements were disposed of at no cost to a Provincial Government Department and the resulting loss on the disposal of these assets was directly accounted for against the accumulated surplus in the statement of changes in net assets. Consequently, the net surplus for the year in the statement of financial performance and the asset disposals deducted from the accumulated surplus in the statement of changes in net assets were overstated by this amount.

#### **Non-current provisions**

26. The municipality did not provide for the rehabilitation of certain landfill sites as required by section 28(1) of the National Environmental Management Act, 1998 (Act No. 107 of 1998) and in accordance with the Standard of Generally Accepted Municipal Accounting Practice, GAMAP 19 *Provisions, contingent liabilities and contingent assets* (GAMAP 19) and stated in accounting policy note 5 to the financial statements. The municipality's records did not permit the performance of reasonable alternative audit procedures regarding the provision for rehabilitation of the landfill sites. Consequently, I did not obtain sufficient appropriate audit evidence as to the completeness and valuation of non-current provisions and property, plant and equipment in accordance with paragraph 28(e) of GAMAP 17, which requires the capitalisation of future rehabilitation costs of an asset to the extent that these costs have been provided for in terms of GAMAP 19. My audit report for the year ended 30 June 2007, dated 23 May 2008, was also modified accordingly.

#### **Payables**

27. Included in the balance of payables as disclosed in note 6 to the financial statements is an amount of R29 044 951 (2007: R29 706 960) which represented receipts which had not yet been allocated to the relevant financial statement line items at 30 June 2008. Since the majority of these payments had not been allocated subsequent to year-end, I could not determine the amount by which payables and receivables were overstated and the amount by which revenue and the inter-company account was understated.
28. An unreconciled difference of R2 831 312 was identified between the balance disclosed in note 6 to the financial statements for retention creditors included under payables and the underlying financial system data for this balance. I could not be provided with appropriate supporting documentation for this difference. Consequently, payables and property, plant and equipment were understated by this amount.

#### **Revenue**

29. Open estimates for water services provided amounting to R16 393 919 (2007: R17 236 589) were included in service charges revenue relating to the sale of water as at 30 June 2008. The service charges revenue relating to the sale of water is overstated by R3 183 864 (2007: R6 720 311) due to the inaccurate open estimates recorded in the financial statements. Consequently, revenue from service charges and consumer debtors are overstated by R3 183 864 (2007: R6 720 311).

### **Capital commitments**

30. The municipality did not maintain a contract register which provides particulars of all approved capital contracts, the expenditure incurred to date and the municipality's future capital commitments in respect of each contract. There were no alternative audit procedures that I could perform to obtain adequate audit assurance that capital commitments to the sum of R59 342 410 (2007: R187 083 410), as disclosed in note 33 to the financial statements, were complete and accurately disclosed in the financial statements. My audit report for the year ended 30 June 2007, dated 23 May 2008 was also modified accordingly.

### **Irregular expenditure**

31. In terms of the MLM's supply chain management policy and section 112(1) of the MFMA, a municipality shall award contracts for goods and services in accordance with a system that is fair, equitable, transparent, competitive and cost-effective. The following irregular expenditure was identified because the above was not complied with. Furthermore, this expenditure was not disclosed in the financial statements as irregular expenditure as required by section 125(2)(d) of the MFMA.

- (a) In respect of payments totalling R6 837 640 (2007: R2 061 413), the number of quotations as required by the council's financial regulations and sections 6 and 7.7 of the municipality's supply chain management policy was not obtained.
- (b) For payments totalling R1 291 436 (2007: R4 727 280) in respect of contracts exceeding R200 000 in value, tenders were not invited.
- (c) In addition to the above, MLM's supply chain management policy was not followed for payments totalling R12 051 564 (2007: R8 854 068) in respect of a combination of the following:
  - Proof of occurrence of catering expenses could not be provided for audit purposes.
  - Tenders were not submitted for audit purposes.
  - Invoices were not in the name of MLM.
  - Payments were not authorised in accordance with section 3.6 of the Delegations of Power Policy or approved delegation of authority letters could not be obtained.

### **Matters arising between parent municipality - MLM and the municipal entity Centlec**

32. The profit on the sale of the electricity distribution department to Centlec in the 2005-06 financial year, as determined by management, amounted to R788 999 047 and was included in the accumulated surplus balance. The ambiguities in the sale-of-business agreement and a lack of supporting documentation with regard to the basis of the valuation and the qualifications of the valuers, I was not able to determine the actual profit on the sale. Consequently, I could not determine the amount by which the accumulated surplus and shareholders loan, which is included under long-term receivables, were misstated. The municipality's records did not permit the performance of alternative audit procedures to obtain adequate audit assurance on the profit on the sale of the electricity distribution department.

33. When comparing the financial statements of MLM with the financial statements of Centlec for the financial year ended 30 June 2008, the following differences were noted with regard to the balance of the inter-entity accounts and the totals of

inter-entity transactions as disclosed in notes 6, 11 and 36 to the financial statements of MLM:

- (a) The balance of the inter-suspense account disclosed in note 6 to the financial statements of MLM amounts to R194 653 900 (2007: R172 811 329) while the balance of this account disclosed in the financial statements of Centlec indicated R198 123 899 (2007: R190 138 944). The resulting unresolved difference is R3 469 999 (2007: R17 327 615). There were no alternative audit procedures that I could perform to obtain adequate audit assurance on the completeness, validity and existence of the inter-suspense account.
  - (b) The balance of the shareholders loan account disclosed in note 11 to the financial statements of MLM amounts to R1 339 348 947 (2007: R1 339 348 947) while the balance of this account disclosed in the financial statements of Centlec amounts to R1 265 482 793 (2007: R1 286 610 608). The resulting difference is R73 866 154 (2007: R52 738 339) which arose due to the fact that Centlec accounted for prepaid interest on the shareholders loan which it deducted from the balance of the shareholders loan as a loan repayment. Consequently, I was unable to determine the valuation of the inter-suspense account for the current and prior financial year.
  - (c) With reference to paragraph 32 above, MLM and Centlec did not negotiate and reach consensus on the interest rate attached to the shareholders' loan as required by the sales agreement. Consequently, MLM recognised interest received on the shareholders loan amounting to R94 000 000 (2007: R96 000 000) while Centlec has recognised interest paid on the shareholders loan amounting to R72 872 184 (2007: R73 107 533). The difference of R21 127 816 (2007: R22 892 467) has deducted from the shareholders loan balance by Centlec in both the current and prior financial year. Consequently, I was unable to determine the accuracy of the interest on the shareholders loan for the current and prior financial year.
34. Advances amounting to R94 838 339 (2007: R60 194 258), as disclosed in note 11, were made by MLM to Centlec after the date of the sales agreement. There is no formal agreement in place between MLM and Centlec that governs the interest rate and repayment terms for these advances. Consequently, I could not determine the rights of the municipality and valuation of this balance and the accuracy of the related interest received.
35. Payments were made by Centlec to MLM via transfers per journal entries for water purchases. No VAT was charged on these transactions and no tax invoices were issued within 21 days as required by the VAT Act. Consequently, VAT payable was understated and the inter-suspense account overstated by R2 145 781 (2007: R8 407 346).

#### **Opening balances**

36. In my previous audit report dated 23 May 2008 I was unable to express an unqualified audit opinion on the financial statements of the municipality for the year ended 30 June 2007. The qualification matters have not been adequately resolved and my audit report regarding the corresponding figures for the year ended 30 June 2008 is modified accordingly.

#### **Disclaimer of opinion**

37. Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit

evidence to provide a basis for an audit opinion on the financial statements of the MLM. Accordingly, I do not express an opinion on the financial statements.

#### **Emphasis of matters**

I draw attention to the following matters:

#### **Amendments to the applicable basis of accounting**

38. The National Treasury approved a deviation from the basis of accounting applicable to the municipality in terms of *General Notice 522 of 2007*, issued in *Government Gazette No. 30013 of 29 June 2007*.

#### **Irregular expenditure**

39. As disclosed in note 39 to the financial statements, irregular expenditure to the amount of R10 137 463 (2007: R4 841 948) was incurred during the current financial year due to non-adherence to supply chain management policy requirements. This reported irregular expenditure is still under investigation.

#### **Unauthorised expenditure**

40. As disclosed in note 41 to the financial statements, non-budgeted expenditure to the amount of R107 235 231 was incurred during the current financial year which is regarded as unauthorised expenditure. This reported unauthorised expenditure is still under investigation.

#### **Restatement of corresponding figures**

41. As disclosed in note 27 to the financial statements, the corresponding figures for the financial year ended 30 June 2007 have been restated as a result of errors discovered during the current financial year in the financial statements of MLM.

#### **OTHER MATTERS**

I draw attention to the following matters that relate to my responsibilities in the audit of the financial statements:

#### **Internal control**

42. Section 62(1)(c)(i) of the MFMA states that the accounting officer must ensure that the municipality has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The table below depicts the root causes that gave rise to the inefficiencies in the system of internal control, which led to the qualified opinion. The root causes are categorised according to the five components of an effective system of internal control. In some instances deficiencies exist in more than one internal control component.

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
<b>Basis for disclaimer of opinion</b>					
Property, plant and equipment	✓				
Long-term receivables			✓		
Consumer and other receivables			✓		

Reporting item	Control environment	Assessment of risks	Control activities	Information and communication	Monitoring
Accumulated surplus			✓		
Non-current provisions	✓				
Payables			✓		
Revenue			✓		
Capital commitments			✓		
Irregular expenditure					✓
Matters arising between parent municipality - MLM and the municipal entity – Centlec			✓		
<p><u>Control environment</u>: establishes the foundation for the internal control system by providing fundamental discipline and structure for financial reporting.</p> <p><u>Risk assessment</u>: involves the identification and analysis by management of relevant financial reporting risks to achieve predetermined financial reporting objectives.</p> <p><u>Control activities</u>: policies, procedures and practices that ensure that management's financial reporting objectives are achieved and financial reporting risk mitigation strategies are carried out.</p> <p><u>Information and communication</u>: supports all other control components by communicating control responsibilities for financial reporting to employees and by providing financial reporting information in a form and time frame that allow people to carry out their financial reporting duties.</p> <p><u>Monitoring</u>: covers external oversight of internal controls over financial reporting by management or other parties outside the process; or the application of independent methodologies, like customised procedures or standard checklists, by employees within a process.</p>					

#### Material non-compliance with applicable legislation

##### 43. Local Government: Municipal Finance Management Act, Act no.56 of 2003 (MFMA)

- Included in gross consumer receivables was an amount of R60 382 733 (2007: R64 765 912) that was due to MLM by government institutions, and R55 379 392 of this balance had been outstanding for longer than 30 days as at 30 June 2008. I could not be provided with evidence that MLM had complied with section 64(3) of the MFMA which requires the accounting officer of MLM to inform National Treasury in writing of any payments from an organ of state in respect of municipal taxes or services which had been outstanding for longer than 30 days.
- Payments to suppliers totalling R26 846 316 (2007: R15 604 518) were not made within 30 days of date of receipt of the relevant invoice or statement, as prescribed by section 65(2)(e) of the MFMA.
- Particulars of non-compliance with the MFMA were not disclosed in the notes to the financial statements as required by section 125(2)(e) of the act.

- Section 17(3)(b) of the MFMA was not complied with as measurable performance objectives for revenue from each source and for each vote in the budget, taking into account the municipality's integrated development plan, were not compiled and presented with the annual budget.
- The municipality did not adhere to sections 22(b), 24(3) and 28(7) as the adjustment budget for 2007-08 was not submitted to National Treasury.
- Section 52(d) of the MFMA was not complied with as not all quarterly reports were tabled and the reports which were tabled were not tabled timeously.
- Section 85(2) of the MFMA was not complied with as not all monies received were deposited in the main bank account of Centlec. Some of the monies received from Centlec customers are currently being deposited into MLM's bank account and subsequently accounted for by Centlec through an inter-company loan account.

#### 44. Local Government: Municipal Systems Act, Act No. 32 of 2000 (MSA)

- In terms of sections 3 and 4 of schedule 1: *Code of Conduct for Councillors* to the MSA, read with rules 13(7) and (8) of the Standing Rules and Orders, Local Government Regulations, published on 1 December 2000, a councillor must pay a fine of 10% of his/her monthly salary if he/she is absent from a council or committee meeting without applying for leave of absence. Notwithstanding the fact that a number of councillors failed to adhere to these rules in at least 90 instances (2007: 64 instances) during the year under review, appropriate sanctions were not imposed on the relevant councillors.
- According to section 63 of the MSA, a political structure, political office bearer, councillor or staff member of a municipality to whom a delegating authority had been delegated or sub-delegated a power or duty must report to the delegating authority at such intervals as the delegating authority may require on decisions taken in terms of that delegated or sub-delegated power. Monthly reports on the delegated powers for the period January to June 2008 could not be obtained for audit purposes.
- Twelve councillors (2007: 15 councillors) failed to declare some of their business interests as required by section 7 of Schedule 1: *Code of Conduct for Councillors* of the MSA.

#### Matters of governance

45. The MFMA tasks the accounting officer with a number of responsibilities concerning financial and risk management and internal control. Fundamental to achieving this is the implementation of certain key governance responsibilities, which I have assessed as follows:

Matter of governance	Yes	No
<b>Audit committee</b>		
• The municipality had an audit committee in operation throughout the financial year.	X	
• The audit committee operates in accordance with approved, written terms of reference.	X	
• The audit committee substantially fulfilled its responsibilities for the year, as set out in section 166(2) of the MFMA.		X
<b>Internal audit</b>		
• The municipality had an internal audit function in operation throughout the financial year.	X	

<b>Matter of governance</b>	<b>Yes</b>	<b>No</b>
• The internal audit function operates in terms of an approved internal audit plan.	X	
• The internal audit function substantially fulfilled its responsibilities for the year, as set out in section 165(2) of the MFMA.		X
<b>Other matters of governance</b>		
• The annual financial statements were submitted for audit as per the legislated deadlines section 126 of the MFMA.	X	
• The annual report was submitted for the auditor for consideration prior to the date of the auditor's report.		X
• The financial statements submitted for audit were not subject to any material amendments resulting from the audit.		X
• No significant difficulties were experienced during the audit concerning delays or the unavailability of expected information and/or the unavailability of senior management.		X
• The prior year's external audit recommendations have been substantially implemented.		X
• PROPAC resolutions have been substantially implemented.		X
<b>Implementation of Standards of Generally Recognised Accounting Practice (GRAP)</b>		
• The municipality submitted an implementation plan, detailing progress towards full compliance with GRAP, to the National Treasury and the relevant provincial treasury before 30 October 2007.	X	
• The municipality substantially complied with the implementation plan it submitted to the National Treasury and the relevant provincial treasury before 30 October 2007, detailing its progress towards full compliance with GRAP.	X	
• The municipality submitted an implementation plan, detailing further progress towards full compliance with GRAP, to the National Treasury and the relevant provincial treasury before 31 March 2008.	X	

## OTHER REPORTING RESPONSIBILITIES

### REPORT ON PERFORMANCE INFORMATION

46. I have reviewed the performance information as set out on pages xx to xx.

#### Responsibility of the accounting officer for the performance information

47. In terms of section 121(3)(c) of the MFMA, the annual report of a municipality must include the annual performance report of the municipality prepared by the municipality in terms of section 46 of the MSA.

#### Responsibility of the Auditor-General

48. I conducted my engagement in accordance with section 13 of the PAA read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008* and section 45 of the MSA.

49. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate audit evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

50. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

**Audit findings (performance information)**

**Non-compliance with regulatory requirements**

**Internal auditing of performance measurements**

51. The internal audit department of the municipality did not audit the performance measurements on a continuous basis and did not submit quarterly reports on their audits to the municipal manager and the performance audit committee, as required by section 45 of the MSA.

**No service delivery agreement**

52. Currently no service delivery agreement is in place between MLM and its municipal entity, Centlec, with regard to the provision of electricity as required by section 76 of the MSA. The previous agreement had lapsed and a new agreement has not yet been concluded.

**Performance management plan not yet approved by council**

53. Section 40 of the MSA requires that a municipality has to establish mechanisms to monitor and review its performance management system. Council has not yet approved MLM's Performance Management Plan.

**Measurable objectives are materially inconsistent between annual report and integrated development plan**

54. I draw attention to the fact that the measurable objectives reported in the annual report of the municipality are materially inconsistent when compared with the predetermined objectives as per the integrated development plan.

55. The following table reflects the material differences:

Objective per integrated development plan	Objective per annual report
<b>Housing directorate</b>	
To ensure that 2 500 households are accommodated in new high density housing with varying tenure options including rent, rent to buy and full ownership.	To ensure that 270 households are accommodated in new high density housing with varying tenure options including rent, rent to buy and full ownership.
<b>Infrastructure directorate</b>	
Exploring alternative ways of delivering municipal services sustainably and efficiently.	Establishment of business units based on approved governance structure.
Ensure the integration of all SDBIPs with the SDF in respect of those elements with spatial implications.	Compilation of infrastructure provision master plan.

**Progress against measurable objectives in the integrated development plan, not reported in the annual performance report**

56. I draw attention to the fact that progress against the following objectives in the integrated development plan of the municipality were not reported on in the annual performance report:

- Infrastructure directorate: Nine objectives relating to administrative support services, project management unit and mechanical services.
- Planning directorate: Ten objectives relating to spatial land use planning, building control and land management.

**Objectives reported in annual report, but not predetermined as per integrated development plan and/or budget**

57. I draw attention to the fact that the following objectives are reported in the annual performance report of the municipality, although they were not included as predetermined objectives in the integrated development plan and/or the budget:

- Infrastructure directorate: Eighteen objectives relating to administrative support services and electricity.
- Planning directorate: Three objectives relating to spatial land use.

**Performance information not received in time**

58. I was not able to complete an evaluation of the quality of the reported performance information as set out on pages xx to xx of the annual report, since the final annual performance report containing all updated performance information was not received in time for audit purposes.

**OTHER REPORTS**

**Investigations**

59. During the 2004-05 financial year an investigation was conducted into allegations of fraud and corruption relating to the tender process, tenders awarded and certain expenditure of the municipality. The investigation had not been completed at the date of this report.

60. An investigation is being conducted by an independent consulting firm on request of the entity during the current financial year. The investigation was initiated based on the allegation of possible abuse of suspense accounts by employees and had resulted in criminal proceedings being instituted against two employees. The investigation had not been completed at the date of this report and the extent of any permanent losses has not yet been established.

**Performance audits**

61. A performance audit concerning infrastructure is in progress. At the date of this report the performance audit had not been completed.

## APPRECIATION

62. The assistance rendered by the staff of the MLM during the audit is sincerely appreciated.

*Auditor - General*

Pretoria

29 November 2008



AUDITOR - GENERAL

**REPORT OF THE AUDITOR-GENERAL TO THE FREE STATE LEGISLATURE, THE COUNCIL OF THE PARENT MUNICIPALITY AND THE BOARD OF DIRECTORS ON THE FINANCIAL STATEMENTS AND PERFORMANCE INFORMATION OF CENTLEC (PTY) LTD FOR THE YEAR ENDED 30 JUNE 2008**

**REPORT ON THE FINANCIAL STATEMENTS**

**Introduction**

1. I was engaged to audit the accompanying financial statements of Centlec (Pty) Ltd which comprise the statement of financial position as at 30 June 2008, statement of financial performance, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes, and the directors' report, as set out on pages [xx] to [xx].

**Responsibility of the accounting officer for the financial statements**

2. The accounting officer is responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting determined by the National Treasury, as set out in accounting policy note 1.1 and in the manner required by the Local Government: Municipal Finance Management Act, 2003 (Act No. 56 of 2003) (MFMA), Companies Act, 1973 (Act No. 61 of 1973) and the Division of Revenue Act, 2007 (Act No. 1 of 2007 (DoRA). This responsibility includes:
  - designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error
  - selecting and applying appropriate accounting policies
  - making accounting estimates that are reasonable in the circumstances.

**Comment [J1]:** I note that paragraphs relating to conditional grants have been included in the qualifications. If Centlec receives grants in terms of DORA then we need to include the reference to DORA also in this par

**Responsibility of the Auditor-General**

3. As required by section 188 of the Constitution of the Republic of South Africa, 1996 read with section 4 of the Public Audit Act, 2004 (Act No. 25 of 2004) (PAA), my responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with the International Standards on Auditing and *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*. Because of the matters discussed in the Basis for disclaimer of opinion paragraphs, however, I was not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.
4. Paragraph 11 *et seq.* of the Statement of Generally Recognised Accounting Practice, GRAP 1 *Presentation of Financial Statements* requires that financial reporting by entities shall provide information on whether resources were obtained and used in accordance with the legally adopted budget. As the budget reporting standard is not effective for this financial year, I have determined that my audit of any disclosures made by Centlec (Pty) Ltd in this respect will be limited to reporting on non-compliance with this disclosure requirement.

## Basis of accounting

5. The municipal entity's policy is to prepare financial statements on the basis of accounting determined by the National Treasury, as set out in accounting policy note 1.1 to the financial statements.

## Revenue

6. Revenue was not recognised and disclosed at fair value as required by the South African Statement of Generally Accepted Accounting Practice (SA GAAP), IAS 18 (AC 111) *Revenue*. Due to the volume of transactions involved I could not quantify the extent by which revenue and finance income has been misstated. No alternative procedures could be performed in this regard.
7. The accounting policy note 1.9.1 is not in accordance with SA GAAP, IAS 18 (AC 111) *Revenue*, since revenue from the sale of prepaid meter vouchers is recognised immediately on receipt of cash and not only at the stage when the entity no longer retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold. As a result, the sale of prepaid electricity revenue was incorrectly recognised as revenue, instead of deferred income as required by SA GAAP, IAS 18 (AC 111) *Revenue*. Due to the volume of transactions involved and the fact that the system could not provide us with the relevant information, I could not quantify the extent by which revenue and deferred income are overstated. No alternative procedures could be performed in this regard.
8. The sale of electricity and receivables were overstated by R3 225 021 due to a system calculation error. A similar misstatement was reported on in paragraph 14(b) of the 2006/07 audit report.
9. I was unable to agree the electricity usage utilised in the calculation of electricity levied to meter reading books. As a result I was unable to confirm the occurrence and accuracy of these transactions.
10. As electricity readings were taken on the 15<sup>th</sup> of each month, the cut-off for electricity revenue was incorrect, resulting in an understatement of R5 069 399. A similar misstatement was reported on in paragraph 14(b) of the 2006/07 audit report.
11. Included in revenue as presented in the statement of financial performance is an amount of R2 286 505 for free services recoverable. Sufficient appropriate audit evidence for the journal underlying this amount could not be provided.
12. The reversal of an incorrect allocation of prepaid electricity revenue to the parent municipality instead of the municipal entity during the previous financial year was incorrectly recognised against revenue for prepaid electricity instead of accumulated surplus. This resulted in the overstatement of the corresponding figure for prepaid electricity by R31 914 065.
13. I could not be provided with sufficient appropriate audit evidence for the following affecting revenue, receivables and inter-company loan account. As a result the occurrence and accuracy of these transactions could not be confirmed. No alternative procedures could be performed in this regard.
  - (a) Meter-reading books used in determining the amount to be recognised as revenue on sale of electricity.

**Comment [j2]:** Why do you say this, would it be possible to provide more detail

**Comment [j3]:** What other section of the audit report is affected by this overstatement of revenue and should you not give more detail as to why you state this over recovery occurred for example was it due to incorrect tariffs loaded etc. Does the municipality have a legal liability to repay these amounts and should they have provided for this liability in terms of the standards?

**Comment [j4]:** This sentence is not very clear. Should it not state I could not agree the electricity usage utilised in the calculation of electricity levied.....

**Comment [j5]:** You can not have a known error and a scope limitation in the same par it does not appear to be correct

**Comment [j6]:** You need to indicate the entire affect of the misstatement in the FS and should it not be the understatement of the comparative. Should this issue not be considered in terms of prior year errors with reference to the necessary statement and consideration of the disclosure requirements.

**Comment [j7]:** If this is a scope limitation which assertions could not be confirmed and what about alternative procedures you are not mentioning anything

**Comment [j8]:** Is this not a duplication of par 9

- (b) Approved policy for the basis used to calculate the levies charged for street and traffic light consumption amounting to R9 256 529. A similar limitation was reported on in paragraph 14(c) of the 2006/07 audit report.
- (c) Year-end adjustment journals amounting to R33 848 034 and R5 933 614 on sale of pre-paid electricity and free services recoverable respectively.
- (d) Differences between the billing system – Actaris and the financial statements for the sale of prepaid electricity amounting to R21 117 386. In the absence of monthly integration reconciliations, the differences could not be explained. A similar limitation was reported on in paragraph 14(c) of the 2006/07 audit report.
- (e) Differences between the sale of electricity revenue recognised in the financial statements and the amount as per the electricity billing system Consbill amounting to R1 428 489. In the absence of monthly integration reconciliations, the differences could not be explained. A similar limitation was reported on in paragraph 14(d) of the 2006/07 audit report.
- (f) Evidence for estimated consumption levied on the electricity billing system: Consbill to the amount of R3 594 556.
- (g) The reclassification of R19 583 250 between revenue from the sale of electricity and revenue from the sale of prepaid electricity made to the comparative (2006/07) disclosure. No alternative procedures could be performed in this regard.

**Comment [j9]:** Should you not also mention something on the disclosure in terms of SA GAAP of prior period errors

#### Other operating income

- 14. Government grants amounting to R24 251 301, as included in other operating income presented in the statement of financial performance, were not recorded as deferred income and recognised as other operating income on a systematic basis over the periods necessary to match with the related costs for which they are intended to compensate, as required by SA GAAP, IAS 20 (AC134) *Accounting for Government grants and disclosure of government assistance*, and in line with accounting policy note 1.9.6. This resulted in the overstatement of other operating income of R24 251 301, the understatement of VAT payable of R116 666, the understatement of deferred income (current liabilities) of R18 657 018 and the overstatement of the inter-company loan account of R5 477 617.
- 15. The entity did not disclose by way of a note the nature and extent of government grants recognised in the financial statements and whether there were any unfulfilled conditions and other contingencies attached to the government assistance that had been recognised as required by SA GAAP, IAS 20 (AC134) *Accounting for government grants and disclosure of government assistance*.

#### Selling, general and administrative expenses

- 16. I could not be provided with sufficient appropriate audit evidence for expenditure amounting to R5 415 623. No alternative procedures could be performed in this regard. I was therefore unable to obtain the required level of audit assurance as to the occurrence, accuracy and classification of expenditure recognised. A similar limitation was reported on in paragraph 17(a) of the 2006/07 audit report.

#### Net finance cost

- 17. Borrowing costs as included in net finance cost presented in the statement of financial performance, were not capitalised as part of the cost of the underlying assets, as allowed by SA GAAP, IAS 23 (AC114) *Borrowing costs*, and in line with

accounting policy note 1.2. As a result of identified weaknesses on the fixed asset register, borrowing costs incurred with regard to constructed assets could not be reliably determined. Net finance cost is therefore overstated and property, plant and equipment understated by an unknown amount.

### Property, plant and equipment

18. As a result of the audit findings detailed below, I was unable to confirm that property, plant and equipment as presented in the statement of financial position have been fairly stated:

**Comment [j10]:** If the paragraphs below is sub paragraphs to this one apply a principal of giving the par number to the Introduction par and then referencing the remainder par's as (a), (b), etc. that give more information with regards the main par.

(a) Management did not review the residual values, useful lives and depreciation methods of assets as required by SA GAAP, IAS 16 (AC 123) *Property, plant and equipment*. Also, management has not assessed whether there is any indication that assets may be impaired, as required by SA GAAP, IAS 36 (AC 128) *Impairment of assets*.

(b) Land and buildings were not revalued in line with accounting policy note 1.2 to the financial statements and the requirements of SA GAAP, IAS 16 (AC 123) *Property, plant and equipment*. I was unable to perform any alternative procedures deemed necessary in determining the extent of the resulting misstatement.

(c) Intangible assets amounting to R3 806 950 were incorrectly recognised as part of property, plant and equipment. Due to the lack of appropriate accounting policy addressing initial and subsequent measurement of intangible assets as required by paragraph 72 of SA GAAP, IAS 38 (AC 129) *Intangible assets*, I was unable to determine the extent by which intangible assets, accumulated surplus, selling, general and administrative expenses are misstated.

(d) Property, plant and equipment funded through government grants as per note 2 to the financial statements, differed from the supporting documentation by R2 697 369, resulting in an understatement of property, plant and equipment and an overstatement of the inter-company loan account by the said amount.

**Comment [j11]:** You got elements of a scope limitation and a financial error in this par. Please reconsider the wording

(e) Paragraph 74(b) of SA GAAP IAS 16 (AC 123) *Property, plant and equipment* requires the entity to disclose assets under construction separately in the financial statements. Assets under construction have not been identified and are not disclosed separately in the financial statements. The entity's records did not permit the performance of alternative audit procedures regarding assets under construction and heritage assets. Consequently, I could not determine the extent to which these assets were inaccurately classified in the financial statements.

**Comment [S12]:**

**Comment [S13]:** Existence and completeness does not seem to be a problem, why then could you not assess the correct classification on your own??

(f) Included in note 2 to the financial statements is cost and accumulated depreciation amounting to R2 035 094 562 for assets as disclosed in the note which were acquired at the inception of Centlec. I could not trace these assets to the fixed asset register and could thus not confirm the existence, valuation and the entities rights relating to these assets. The entities records and systems did not permit me to perform reasonable alternative procedures in this regard.

**Comment [j14]:** Are there any that you are aware of as the par is not clear that this is an issue because you are not indicating that you have identified assets of this nature that need to be disclosed

### Long term receivables

19. I could not be provided with sufficient appropriate audit evidence for amounts recognised as long term receivables. As a result of the before mentioned, I was unable to confirm that both the long-term and short-term portions of the long-term receivables, with closing balances at year end of R5 589 815 and R513 058 respectively, were fairly stated.

**Comment [j15]:** You have to report to your assertions please reconsider

## Inventory

20. During the year-end inventory count, I noted that not all the inventory of the entity was included in the counting process or on the inventory records that were utilised to prepare the financial statements. Omitted items included fibre optical cables and transformers previously issued to projects that had been returned as unused. Management could not provide me with reasonable explanations as to why these items were not included in the total inventory listing and disclosure. As a result the value of inventory is understated and repairs and maintenance is overstated. Given the number and nature of the stock items involved I was unable to quantify the resulting misstatement.

## Inter-company loan account

21. The inter-company loan account was not initially recognised at fair value and subsequently measured at amortised cost using the effective interest rate method as required by SA GAAP, IAS 39 (AC 133) *Financial instruments: Recognition and measurement*. I was unable to quantify the misstatement due to the material effect of scope limitations, identified misstatements and other issues of non-compliance with SA GAAP affecting the inter-company loan account as reported in the various financial statements line items within this report.
22. Material net adjustments totalling R7 984 955 were made to the loan account in respect of which management was unable to provide me with sufficient appropriate audit evidence. No alternative procedures could be performed in this regard.

**Comment [j16]:** If you refer to non compliance with SA GAAP you should provide the detail. Please reconsider

**Comment [j17]:** You need to reference to the disclosure in the statements

## Receivables and prepayments

23. As a result of the audit findings detailed below, I could not confirm that accounts receivables and prepayments as presented in the financial statements have been fairly stated:
- (a) Receivables and prepayments as per note 5 to the financial statements were not initially recognised at fair value and subsequently measured at amortised cost using the effective interest rate method as required by the South African Statement of GAAP, IAS 39 (AC 133) *Financial instruments: Recognition and measurement*. Due to the volume of transactions involved, I could not quantify the extent by which accounts receivables and prepayments, net profit for the year and accumulated surplus are misstated in this regard.
- (b) I could not obtain proof that receivables and prepayments have been impaired in accordance with the requirements of SA GAAP, IAS 36 (AC 128) *Impairment of assets*. The entity only made a general provision for doubtful receivables.

**Comment [j18]:** You need to report to your assertions. Also if this is an introductory par it needs to be numbered and all ancillary par then need to be numbered as (a), (b) etc

As the relevant information was not available, I was not able to determine what the impairment charge should have been had IAS 36 been applied correctly. I was therefore unable to quantify the amount by which accounts receivables and prepayments, net profit for the year and accumulated surplus for the year are misstated in this regard.

- (c) A difference of R6 355 801 was identified between the consumer debtors as per the financial statements, and the debtors' age analysis as per the debtors' sub-ledger. A difference of R83 669 451 was also identified between the consumer debtors' balance as per the age analysis and the total of the individual balances as per the debtors' transaction files. In the absence of monthly integration reconciliations, the

**Comment [j19]:** I suggest that you quantify the difference rather than just indicating that they are material

differences could not be explained. As a result receivables might be materially misstated.

- (d) In addition to the above, the financial statements does not make reference to the fair value of the Receivables and prepayments account balance in such a way that permits it to be compared with its carrying amount.

#### Accumulated surplus

24. Management was unable to provide me with sufficient appropriate audit evidence as to the occurrence, accuracy and classification of expenditure transactions amounting to R55 717 339 as incorporated in the accumulated surplus balance at 30 June 2006 presented in the statement of changes in net assets. The entity's records also did not permit me to perform reasonable alternative procedures with regard to these expenditure transactions.

#### Interest-bearing borrowings

25. Included in interest bearing borrowings as disclosed in note 9 to the financial statements is a Capital Purchase Loan to the value of R94 838 338. There is no agreement in place in respect of this loan that governs the applicable interest rate and repayment terms. Consequently, I am unable to confirm the obligation of the entity and the valuation of this balance or the accuracy of the related interest received. This issue was also reported in paragraph 9(a) of our 2006/07 audit report.
26. Notwithstanding the effect of paragraph 25 above, the entity did not comply with paragraph 43 and 47 of SA GAAP, IAS 39 (AC133) *Financial Instruments: Recognition and measurement* regarding both the initial and subsequent measurement of the interest bearing borrowings. Interest-bearing borrowings were not initially recognised at fair value and subsequently measured at amortised cost using the effective interest rate method. I am unable to quantify the extent by which interest bearing borrowing, accumulated surplus and finance cost is misstated by. Due to the unavailability of documentation as referred to in paragraph 25, no reasonable alternative procedures could be performed in this regard.
27. The nature and extent of risks the entity is exposed to resulting from this capital purchase loan account balance was not disclosed as required by SA GAAP, IFRS 07 (AC 144) *Financial instruments: Disclosures*. As required by IFRS 7, the fair value of the interest-bearing borrowings necessary to permit comparison with carrying amount of financial instrument recognised was also not disclosed.

**Comment [j20]:** Rights is not the correct assertion when considering borrowings should it not be obligations

**Comment [j21]:** Is this reference correct

**Comment [j22]:** What is the requirements of the SA GAAP include this detail in the par

**Comment [j23]:** When you indicate no alternative procedures could be performed you also need to give some indication of why not i.e. was it systems that did not permit you to get the necessary info or was it the unavailability of documentation

#### Shareholders loan

28. In terms of the sale-of-business (SOB) agreement effective from 01 July 2005 entered into between Mangaung Local Municipality (MLM) and Centlec according which MLM electricity department function was transferred to Centlec, the acquisition of MLM electricity assets was financed with a shareholder loan obtained from MLM.

Upon the review of this agreement, I could not reliably determine the loan inception amount given the identified ambiguities in the SOB agreement related to the value of assets acquired and the loan inception amount in terms of this agreement. I could not obtain any other documentation to enable me to determine the loan inception amount. Furthermore, both MLM and Centlec had for the past three financial year-ends been presented amounts materially different regarding this account balance. This issue was reported on in the previous years. No other alternative audit

procedures could be performed to determine what the loan inception amount and the value of related assets.

As a result, I could not perform all the audit procedures I consider necessary to confirm the valuation of the shareholder loan, accumulated surplus and the related electricity assets included in property, plant and equipment and the accuracy of finance costs as presented in the financial statements.

29. Notwithstanding the effect of the finding above, I have noted that neither the initial nor subsequent measurement on this shareholders loan was accounted for in accordance with paragraph 43 and 47 of SA GAAP, IAS 39 (AC133) *Financial Instruments: Recognition and measurement*. In terms of this standard the entity should have recognised the discount, resulting from the below market interest rate on which interest payment is determined, as a gain in the statement of financial performance. Also the interest expense recognised should have been determined using a risk-adjusted market interest rate. The discount was incorrectly accounted for as part of the shareholder loan balance while interest expense recognised was determined using discounted interest rate. As a result, shareholder loan, accumulated surplus, finance cost are misstated. Due to identified ambiguities in the SOB agreement referred to paragraph 28 above, I am unable to quantify the extent to which shareholder loan, accumulated surplus and finance cost are misstated. This issue was reported on in the previous financial years.
30. I have noted that amounts paid as interest in excess of what is specified as payments in the SOB agreement were treated as a reduction in the shareholder loan balance. The SOB agreement is silent on what the treatment of excess payment should be and these voluntary excess payments would not have been included in the initial measurement calculation of the shareholder loan given that these calculations would have been based on the terms and conditions of the SOB agreement. Therefore, amount paid in excess of what is specified as payments in the SOB agreement should be recognised as a debtor. As a result both shareholder loan and the intercompany loan account are understated. Due to identified ambiguities in the SOB agreement referred to in paragraph 43 above, I am unable to quantify the extent to which shareholder loan and intercompany loan account are understated.
31. The nature and extent of risks the entity is exposed to resulting from the shareholder loan account balance, were not disclosed as required by SA GAAP, IFRS 07 (AC 144) *Financial instruments: Disclosures*. Contrary to IFRS 7, the fair value of the interest-bearing borrowings necessary to permit comparison with carrying amount of financial instrument recognised was also not disclosed.

#### Consumer deposits - services

32. Due to the lack of sufficient appropriate audit evidence for consumer deposits totalling R3 264 517 as identified in the debtors' sub-ledger the nature thereof could not reasonably be determined. Consequently, I could not confirm obligation, existence and valuation of these deposits.

Comment [j24]: This sentence does not read correctly please reconsider the wording

#### Payables

33. As a result of the findings detailed below, I could not confirm whether or not trade and other payables as presented in Note 12 to the financial statements are fairly stated:

Comment [j25]: Main part to

- (a) I could not be provided with a payables listing for both current and prior year to support trade payables amounting to R54 703 562 included in note 12 to the financial statements. The systems did not permit me to perform reasonable alternative procedures in this regard. As a result, I was unable to perform all the procedures necessary to confirm the existence, completeness, valuation and the entities obligation in terms of disclosed trade payables.
- (b) Due to the entities financial system control weaknesses, I was unable to determine the creditor payment history. As a result of these weaknesses and the lack of a creditor listing, I was unable to confirm that trade payables were initially recognised at fair value and subsequently measured at amortised cost using the effective interest rate method as required by SA GAAP, IAS 39 (AC 133) *Financial instruments: Recognition and measurement*.
- (c) As disclosed in the directors' report, the entity has applied for exemption from normal tax as per section 10(1)(cA) of the Income Tax Act, 1962 (Act No. 58 of 1962). As at year-end, however had not yet been granted exemption from normal tax by the Commissioner of South African Revenue Services. In the absence of the above exemption, the entity had a present legal obligation to recognise a current tax liability as well as a deferred tax liability as required by SA GAAP, IAS 12 (AC 102) *Income taxes*. This issue was also reported on in the previous year. Due to the material effect of scope limitations, misstatements and other issues of non-compliance with SA GAAP, IAS 18 (AC 111) *Revenue* and IAS 39 (AC 133) *Financial instruments: recognition and measurement* and IAS 16 (AC 123) *Property, plant and equipment* referred to in this report, I was unable to quantify the extent by which the income tax liability, deferred tax, accumulated surplus and income tax expense are misstated in this regard.
- (d) Based on a comparison made between the financial statements and the last VAT201 return for the period under review, a difference of R19 812 881 was identified. Due to the lack of VAT reconciliations, the difference could not be explained. Due to the lack of sufficient appropriate audit evidence, I am thus unable to determine the affected account balances, classes of transactions and disclosures in the financial statements.
- (e) A difference of R3 311 299 was identified between the consumer debtors with credit balances as included in payables presented in the financial statements, and the age analysis as per the debtors' sub-ledger. A difference of R6 388 704 was also identified between the consumer debtors' balance as per the age analysis and the total of the individual balances as per the debtors' transaction files. In the absence of monthly integration reconciliations, the difference could not be explained. The systems did not permit me to perform reasonable alternative procedures in this regard.
- (f) The VAT creditor amounting to R8 963 050 at 30 June 2008 was not presented separately on the face of the statement of financial position, as required by paragraph 80 of GRAP1 *Presentation of financial statements*.

**Comment [J26]:** I suggest that you quantify the difference rather than just indicating that they are material

#### Contingent liabilities

34. Paragraph 10 of SA GAAP, IAS 37 (AC130) *Provisions, Contingent Liabilities and Contingent Assets* defines a contingent liability as: (a) a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly

within the control of the entity; or (b) a present obligation that arises from past events but is not recognised because: (i) it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or (ii) the amount of the obligation cannot be measured with sufficient reliability. I have identified several amounts totalling R5 680 050 which should have been disclosed as contingent liabilities. No disclosure is made in the financial statements regarding this identified contingent liability.

**Comment [j27]:** Should you not provide the reader with the detail of the contingent liability that should have been disclosed

#### Contingent assets

35. Paragraph 10 of SA GAAP, IAS 37 (AC130) *Provisions, Contingent Liabilities and Contingent Assets* states defines a contingent asset as a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity. I have noted that note 21 to the financial statements discloses a contingent asset of R30 000 000. This contingent asset should not have been disclosed since an inflow of economic benefits is not probable, as required by paragraph 89 of SA GAAP, IAS 37 (AC130) *Provisions, Contingent Liabilities and Contingent Assets*.

#### Capital commitments

36. Contrary to the requirements of SA GAAP, IAS 15 (AC 123) *Property, plant and equipment*, no information regarding the amount of contractual commitments for the acquisition of property, plant and equipment is disclosed in the annual financial statements. Contractual commitments totalling R9 011 553 were identified for which no information was disclosed.

#### Financial assets and liabilities

37. Financial assets and liabilities are not classified and disclosed in the financial statements in accordance with SA GAAP, IAS 39 (AC 133) *Financial instruments: Recognition and measurement*, SA GAAP, IAS 32 (AC 125) *Financial instruments: Presentation* and SA GAAP, IFRS 07 (AC 144) *Financial instruments: Disclosures*.

**Comment [j28]:** Why do you state this if par 58 is subordinate to this par and provide the detail refer to the reasons as detailed below and reference the par as (a), (b) etc to indicate that it is supplementary to par 57

38. The standard requires that financial assets and liabilities have to be divided into the following categories:

- Financial assets or financial liabilities at fair value through profit or loss
- Held-to-maturity investments
- Loans and receivables
- Available-for-sale financial assets.

39. I was also unable to confirm the valuation of the amounts as disclosed in note 18 to the financial statements due to the material effect on this note of scope limitations, identified misstatements and other issues of non-compliance with SA GAAP affecting financial instruments as reported in the various financial statements line items within this report.

**Comment [j29]:** Correctness is not an assertion should you not say something on valuation

40. The amount that best represents Centlec's maximum exposure to credit risk, and information regarding the credit quality of the financial assets and liabilities, that is neither past due nor impaired, was not disclosed as required by SA GAAP, IFRS 7 (AC 144) *Financial Instruments: Disclosures*.

## Related parties

41. I was unable to quantify the misstatements regarding related-party transactions due to the material effect of scope limitations, identified misstatements and other issues of non-compliance with SA GAAP affecting related-party transactions as reported on in the various financial statements line items within this report. The entity does not have a documented system of identifying, recording and reporting on related-party transactions.

42. I could also not obtain confirmation of related-party transactions and balances from the parent entity. When comparing the information as per note 19 to the financial statements with the financial statements of the parent municipality for the year ended 30 June 2008, the following differences, also reported on in the previous financial years, were noted with regard to the balances of the inter-entitly accounts and the totals of inter-entitly transactions:

(a) The balance of the inter-company loan account disclosed in note 13 to the financial statements of the entity amounts to R198 123 899 while the balance of this account disclosed in the financial statements of the parent municipality is disclosed as R194 653 900. The resulting unresolved difference is R3 469 999 . There were no alternative audit procedures that I could perform to obtain adequate audit assurance on the completeness, validity and existence of the inter-company control account. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report.

(b) The balance of the shareholders loan account disclosed in note 7 to the financial statements of Centlec amounts to R1 265 482 793 while the balance of this account disclosed in the financial statements of the parent municipality amounts to R1 339 348 947. The resulting difference is R73 866 154 arose due to the fact that the entity accounted for prepaid interest on the shareholders loan which it deducted from the balance of the shareholders loan as a loan repayment. Consequently, I was unable to determine the valuation of the inter-company control account for the current and prior financial year. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report.

**Comment [j30]:** Check your references as you are comparing Centlec with Centlec according to the par

(c) The entity and its parent municipality did not negotiate and reach consensus on the interest rate attached to the shareholders' loan, as required by the SOB agreement. Consequently, the entity recognised interest paid on the shareholders loan amounting to R72 872 184 while the parent municipality has recognised interest received on the shareholders loan amounting to R94 000 000. The difference of R21 127 816 has been deducted from the shareholders loan balance by the entity in both the current and prior financial year. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report.

Consequently, I was unable to determine the accuracy of the interest on the shareholders loan for the current and prior financial year.

(d) Capital purchase loans amounting to R94 838 339, as disclosed in note 9 to the financial statements, were acquired by the entity from its parent municipality after the date of the sales agreement. There is no formal agreement in place between the parties that governs the interest rate and repayment terms for these advances. A similar limitation was reported on in paragraph 9(a) of the 2006/07 audit report.

Consequently, I could not determine the valuation, existence and completeness of this balance and the accuracy of the related interest paid.

The interest paid by the entity to its parent municipality in respect of these capital purchase loans for the year ended 30 June 2008, amounting R6 428 059, are not disclosed in note 19 to the financial statements. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report

- (e) The management fees disclosed in note 16 to the financial statements amounts to R73 960 028, while the transaction value disclosed in the financial statements of the parent municipality amounts to R74 559 732. The resulting unresolved difference is R599 704. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report.
- (f) The comparative figure for services rendered by the parent municipality to the entity, as disclosed in note 19 to the financial statements amounting R7 906 868 does not agree to the transaction value of R7 769 031, as disclosed in the financial statements of the parent municipality. The resulting difference of R137 837 remains unresolved at 30 June 2008. Consequently, the occurrence, completeness, accuracy, cut-off and classification of the transaction value for services rendered by the parent to the entity, as disclosed, could not be confirmed.
- (g) The related party disclosure note 19 omits the disclosure of transaction values relating to electricity sales to the parent and water purchases from the parent. The financial statements of the parent municipality disclose the transaction value for water sold to the entity as R19 756 and electricity purchases from the entity as R12 135 029. A similar limitation was reported on in paragraph 26(a) of the 2006/07 audit report.

#### Irregular expenditure

43. Irregular expenditure was not reported as required by section 102(1) of the MFMA. Also, no disclosures were made in the financial statements in this regard, as required by section 125(2)(d)(i) of the MFMA. The following instances of irregular expenditure were identified:

- (a) Expenditure amounting to R18 148 317 was incurred contrary to the entity's supply chain management policy (SCM). This amount includes an amount of R701 015 in respect of which no signed contracts were available as prescribed. A similar misstatement was reported on in paragraph 21(b) of the 2006/07 audit report.
- (b) In contradiction with section 87(8) of the MFMA the entity incurred expenditure amounting to R9 715 929 that was not in accordance with its approved budget or an adjustments budget.
- (c) I could not be provided with written delegation of powers in respect of expenditure amounting to R2 444 871, as required by section 106 of the MFMA. A similar misstatement was reported on in paragraph 21(a) of the 2006/07 audit report.
- (d) I could not be provided with contracts for tenders totalling R25 289 560. Furthermore, details for a list of contracts could not be submitted in order to monitor compliance with the required procurement processes regarding the bidding process. I could also not be provided with advertisements in this regard. This placed a material limitation on the scope of the audit.
- (e) I could not be provided with a service delivery agreement entered into with the service provider for the provision of pre-paid electricity. Expenditure amounting to R3 718 899 was incurred in this regard.

**Comment [j31]:** Your main par should be numbered and any detail to the main par should be referenced as (a), (b) etc

- (f) Awards totalling R6 127 888 were made to suppliers for the rendering of goods or services for whom the required tax clearance certificates were not obtained.

#### **Cash flow statement**

44. I am not able to determine whether or not the cash flow statement and the related notes are fairly stated due to the material effect of scope limitations, identified misstatements and other issues of non-compliance with SA GAAP as reported in the various financial statements line items within this report affecting cash flow statement and related notes.

#### **Other compulsory disclosures**

45. The entity did not comply with section 125(2)(d)(i) of the MFMA since material distribution losses totalling an estimated amount of R75 286 881 were not disclosed in the notes to the financial statements.
46. The entity did not comply with section 124(2)(b) of the MFMA since the particulars of salaries, allowances and benefits of every senior manager amounting to R2 892 311 in total was not disclosed in the notes to the financial statements.
47. The particulars of the executive directors' emoluments were not separately disclosed in note 17 to the financial statements, as required by section 297(1) of the Companies Act, 1973 (Act No. 61 of 1973). Included in management fees is an amount of R1 033 361 in respect of the directors' remuneration for the CFO. Furthermore staff costs as presented in the statement of financial performance includes an amount of R1 167 696 in respect of the directors' remuneration for the CEO.

#### **Corresponding figures**

48. In my previous audit report dated 27 August 2008 I was unable to express an audit opinion on the financial statements of the municipal entity for the year ended 30 June 2007. The qualification matters have not been adequately resolved and my audit report is modified regarding the corresponding figures.

#### **Disclaimer of opinion**

49. Because of the significance of the matters described in the Basis for disclaimer of opinion paragraphs, I have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on the financial statements of Centlec (Pty) Ltd. Accordingly, I do not express an opinion on the financial statements.

#### **Emphasis of matters**

I draw attention to the following matter:

#### **Restatement of corresponding figures**

50. As disclosed in note 27 to the financial statements, the corresponding figures have been restated as a result of various errors discovered during the previous audit and the current year in the financial statements of Centlec (Pty) Ltd for the year ended 30 June 2007.

## OTHER MATTERS

I draw attention to the following matters that relate to my responsibilities in the audit of the financial statements:

### Internal controls

51. Section 95(c)(i) of the MFMA states that the accounting officer must ensure that the municipal entity has and maintains effective, efficient and transparent systems of financial and risk management and internal control. The table below depicts the root causes that gave rise to the inefficiencies in the system of internal control, which led to the disclaimer of opinion. The root causes are categorised according to the five components of an effective system of internal control. In some instances deficiencies exist in more than one internal control component.

Reporting Item	Control environment	Risk assessment	Control activities	Information and communication	Monitoring
Revenue			X		
Other operating income			X		
Selling, administrative and general expenses			X		
Net finance cost	X		X		
Property, plant and equipment	X		X		
Long term receivables	X		X		
Inventory			X		
Intercompany loan account	X		X		
Receivables and prepayments			X		
Accumulated surplus			X		
Interest bearing borrowings	X		X		
Shareholder loan	X		X		
Consumer deposits services			X		
Payables	X		X		
Contingent liabilities			X		
Contingent assets			X		

Reporting item	Control environment	Risk assessment	Control activities	Information and communication	Monitoring
Capital commitments			X		
Financial assets and liabilities			X		
Related parties	X		X		
Irregular expenditure			X		
Corresponding figures	X		X		

**Control environment:** establishes the foundation for the internal control system by providing fundamental discipline and structure for financial reporting.

**Risk assessment:** involves the identification and analysis by management of relevant financial reporting risks to achieve predetermined financial reporting objectives.

**Control activities:** policies, procedures and practices that ensure that management's financial reporting objectives are achieved and financial reporting risk mitigation strategies are carried out.

**Information and communication:** supports all other control components by communicating control responsibilities for financial reporting to employees and by providing financial reporting information in a form and time frame that allows people to carry out their financial reporting duties.

**Monitoring:** covers external oversight of internal controls over financial reporting by management or other parties outside the process; or the application of independent methodologies, like customised procedures or standard checklists, by employees within a process.

#### Non-compliance with applicable legislation

The following material non-compliance issues were identified:

##### Companies Act, 1973 (Act No. 61 of 1973)

52. Proof that the annual financial statements submitted to the Auditor-General's office on 31 August 2008 had been approved by the board of directors, as required by section 298 of the Companies Act, 1973 (Act No. 61 of 1973), could not be submitted.
53. Section 240 of the Companies Act, 1973 (Act No. 61 of 1973) was not complied with, as the register of directors' interest in contracts were not kept.

##### Municipal Finance Management Act, 2003 (Act No. 56 of 2003)

54. Section 87(5)(d) of the MFMA was not complied with as an approved multi-year business plan for the entity could not be provided to me.
55. Section 88 of the MFMA was not complied with as the mid-year assessment of the budget performance made no reference to progress on targets set in terms of service delivery.

56. Sections 87(8) and 100 of the MFMA was not complied with as proper budget control was not implemented.
57. Section 127(1) of the MFMA was not complied with as the annual reports for the previous two financial years were not submitted to the municipal manager of the parent municipality.
58. Section 95(c)(i) of the MFMA was not complied with as the risk committee was not functional during the period under review. Progress reports with regard to addressing the risks identified by means of a risk assessment could also not be obtained.
59. Section 99(2)(b) of the MFMA was not complied with as the entity did not pay all invoices within 30 days of receiving thereof.
60. Section 104(1)(b) of the MFMA was not complied with as the accounting officer did not submit to National Treasury a separate report for each contract awarded above R100 000, as contemplated in MFMA circular No. 34.

#### Matters of governance

61. The MFMA tasks the accounting officer with a number of responsibilities concerning financial and risk management and internal control. Fundamental to achieving this is the implementation of certain key governance responsibilities, which I have assessed as follows:

Matter of governance	Yes	No
<b>Audit committee</b>		
• The municipal entity had an audit committee in operation throughout the financial year. EX13		X
• The audit committee operates in accordance with approved, written terms of reference.		X
• The audit committee substantially fulfilled its responsibilities for the year, as set out in Section 166(2) of the MFMA.		X
<b>Internal audit</b>		
• The municipal entity had an internal audit function in operation throughout the financial year. EX10		X
• The internal audit function operates in terms of an approved internal audit plan.		X
• The internal audit function substantially fulfilled its responsibilities for the year, as set out in Section 165(2) of the MFMA.		X
<b>Other matters of governance</b>		
• The annual financial statements were submitted for audit as per the legislated deadlines in section 126 of the MFMA.	X	
• The annual report was submitted to the auditor for consideration prior to the date of the auditor's report.	X	
• The financial statements submitted for audit were not subject to any material amendments resulting from the audit.		X
• No significant difficulties were experienced during the audit concerning delays or the unavailability of expected information and/or the unavailability of senior management.		X

Matter of governance	Yes	No
<ul style="list-style-type: none"> <li>The prior year's external audit recommendations have been substantially implemented.</li> </ul>		X

#### Unaudited supplementary schedules

62. The supplementary income statement set out on pages xx to xx do not form part of the financial statements and is presented as additional information. I have not audited this and accordingly I do not express an opinion on it.

#### OTHER REPORTING RESPONSIBILITIES

##### REPORT ON PERFORMANCE INFORMATION

63. I was engaged to review the performance information.

##### Responsibility of the accounting officer for the performance information

64. In terms of section 121(4)(d) of the MFMA, the annual report of a municipal entity must include an assessment by the entity's accounting officer of the entity's performance against any measurable performance objectives set in terms of the service delivery agreement or other agreement between the entity and its parent municipality.

##### Responsibility of the Auditor-General

65. I conducted my engagement in accordance with section 13 of the PAA read with *General Notice 616 of 2008*, issued in *Government Gazette No. 31057 of 15 May 2008*.

66. In terms of the foregoing my engagement included performing procedures of an audit nature to obtain sufficient appropriate evidence about the performance information and related systems, processes and procedures. The procedures selected depend on the auditor's judgement.

67. I believe that the evidence I have obtained is sufficient and appropriate to provide a basis for the audit findings reported below.

##### Audit findings (performance information)

##### Non-compliance with regulatory requirements

68. Contrary to section 93B of the Municipal Systems Act, 2000 (Act No. 32 of 2000) the parent municipality did not by agreement with the municipal entity establish annual performance objectives and key performance indicators for the municipal entity to be included in the municipal entity's multi-year business plan. Key financial and non-financial performance objectives and measurements criteria were therefore not agreed with the parent municipality, as contemplated in section 87(5)(d)(i) of the MFMA.

As a result an assessment was not performed by the entity's accounting officer of the entity's performance against any measurable performance objectives as required by section 121(4)(d) of the MFMA.

## APPRECIATION

69. The assistance rendered by the staff of Centlec (Pty) Ltd during the audit is sincerely appreciated.

Bloemfontein

30 November 2008



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